# The Impact of Racial Diversity of Executive Managers on Financial Performance of South African State-Owned Enterprises

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## ABSTRACT

Globally corporate company are embracing both gender and racial diversity and they are beginning to witness its impact on performance. Several researchers have revealed that with increased diversity, companies can gain access to unique networks, information and human capital which ultimately improves financial performance (Carter, D'Souza, Simkins, & Simpson, 2010). In this paper, we investigate whether racial diversity at executive management level bears financial benefits, particularly in a South African context where since the dawn of democracy, regulations such as the Employment Equity Act of 1998 require companies to racially diversify their workforce. This research analyses data from 21 major State Owned Companies (SOC) from (2011 to 2014). The study used correlation and regression analysis to examine the relationship between the racial composition of executive managers (i.e. whether they are Black, White, Indian or coloured) in these companies and the companies' financial performance (i.e. Profit Margin, Return on Assets as well as Fruitless and Wasteful Expenditure as a percentage of revenue).

The results indicate that there is slow progress made by the South African government on including blacks at their executive management teams within SOCs. Furthermore, we also find no correlation between the racial diversity of the management teams and the financial performance) of these SOCs.

These findings are significant, particularly for South African regulators and policy makers, as they provide justification for increased efforts to racially diversify the South African executive management teams in SOCs. This is important since numerous studies have demonstrated that such diversity was financially beneficial particularly in the private sector.

**Key words**

state-owned companies, racial diversity, financial performance

# Introduction

Globally over the past few decades, the number of women and ethnic minorities has increased in the boardrooms of companies (Hillman, Cannella & Harris, 2002). The justification behind such increases has been to address gender and racial imbalances in the corporate environment.

Over and above rectifying the inequalities of the board room, some companies that have embraced diversity have realised significant increases in workforce productivity and performance. Some researchers argue that a diverse workforce that includes women and racial minorities drives economic growth (Burns, Barton & Kirby, 2012).

It is also suggested that with increased diversity, governance is improved which results in improved financial performance (Carter, D'Souza, Simkins, & Simpson, 2010). These researchers further state that for companies to embrace diversity they should witness diversity translating into improved financial performance.

Most studies that have looked at the impact of board and management diversity were initially focused on developed countries (Shleifer & Vishny, 1997; and Vafeas & Theodorou, 1998). It has only been over the recent years that there has been a growing number of research publications on developing countries (See for instance Abidin, Kamal, & Jusoff, 2009; Baek, Kang & Park, 2004; Haniffa & Hudaib, 2006) with only a few studies that have investigated this subject in the South African context (Ho & Williams, 2003; Mangena & Chamisa, 2008; Okeahalam, 2004).

In South Africa a study that focuses on the impact of racial diversity is necessary as the country has had a long history of racial discrimination and over the past two decades' legislations and policies such as the Employment Equity Act of 1998 (EEA) and the affirmative action (AA) programmes that have been adopted to rectify these past inequalities. These laws were implemented in order to drive transformation in South Africa's corporate environment (including SOCs) and redress the racial imbalances of the past. Consequently, the progress as well as the impact of these anti-racism laws and policies have drawn the interest of researchers.

According to Sebola (2009), AA policies are concentrated on balancing corporate demographics and this often leads to the appointment of poorly qualified and incompetent employees in particular positions. Such a problem emanates from two perspectives, namely, political nepotism or lack of suitable candidates from the designated groups. These two problems disregard the need for serving the public efficiently and effectively especially in the public sector. Bullard (2007:3) states that in principle, there is nothing wrong with AA policies and addressing the principles of the past inequalities, but it is equality important for these AA programs to enhance the economic needs of the country and the delivery of efficient public services. He also argued that AA programs are an insult to qualified black employees as it is sometimes perceived that black applicants are unable to compete as equals against white applicants.

In this study we will therefore focus on the impact of racial diversity (a component of affirmative action) on financial performance on all major SOCs. The present study will therefore analyse the implementation of EEA and AA policy by government on SOC in terms of racial diversity. In addition, the study will also indicate how racial diversity has affected the SOCs financial performance. The article therefore seeks to establish whether there is a business case supporting racial diversity in SOC.

In the next section of the article we discuss the literature related to racial diversity in South Africa's corporate environments, the role and performance of SOC, as well as the link between racial diversity of management and financial performance of companies.

# Literature review

## The Role of State Owned Companies and their performance

The role of executive managers' in an organisation is critical, as managers are involved in the day to day operation of the business and they have to ensure that the organizations are operating efficiently and are financially sound. The level of diversity that these managers bring to the companies is therefore vital to the role they play. As a result, this article looks at the impact of racial diversity on financial performance of SOCs.

After the Second World War, many countries worldwide established SOCs. These SOCs were formed in order to redress market failures that were created by the war and to provide essential basic services such as telecommunications, aviation, nuclear energy and electricity to the public. Since such services were too expensive to be deployed by the private sector SOCs were established in order to deliver these services and yield both a financial and social return for the capital invested in them by the government (Heath & Norman, 2004).

According to the Organisation for Economic Co-operation and Development's (OECD) 2004 comparative report on the corporate governance of SOCs, some of the governments in OECD countries still own a majority of the businesses in essential sectors such as energy, transport and telecommunications. In developing countries, the SOC plays a much more important role as they are also expected to promote economic development and equity (Kaldor, 1980).

A study by Balassa (1993:14) on public enterprises in developing countries concluded that:

> The role of the public sector in providing economic and social infrastructure, meeting certain public needs of the community, promoting science and technology for development, assuring better distribution of wealth and opportunities and mobilising of resources is accepted universally.

Similarly, in South Africa during the apartheid era, SOCs were given an economic development mandate. These entities assumed a dominant role in key infrastructure areas such as rail, air and sea transport, telecommunications, water, coal-based synthetic fuels as well as nuclear energy. The government also viewed these industries as being important for industrialisation, employment creation and economic development. Unfortunately, during this period, there was racial segregation and white South Africans were the only beneficiaries.

Thus, post-apartheid it was expected that the primary position of the South African democratic government would be to transform these SOCs (Thabethe, 2010) by employing blacks; women and physically disadvantaged individuals.

McGregor (2014) reveal that in South Africa SOCs play a crucial role in providing economic infrastructure, they serve the needs of capital-intensive industry; assist with sustainable job creation; they promote Black Economic Empowerment; and help governments to implement Employment Equity by eliminating previous apartheid discrimination practices.

The financial measurement and monitoring of these SOCs is therefore important. According to a 2004 OECD report on state-owned enterprises, SOEs are required to publish their annual financial statements which are subjected to examination and review by their stakeholders.

In South Africa, the Public Finance Management Act (PFMA) of 1999 was adopted to make financial management in the public sector more efficient in order to reduce fraud, corruption and wasteful expenditure as curbing these elements would result in public funds being utilised efficiently for service delivery. The PFMA establishes clear lines of accountability and broad frameworks of best practice that managers are required to adopt. Any executive manager underspending or underperforming would be transgressing the Act and would be open to the specified sanctions. Transgressions include unauthorised, irregular, fruitless or wasteful expenditure. Fruitless or wasteful expenditure is an expenditure made in vain, which could have been avoided had reasonable care been exercised.

Worldwide, the performance of most SOCs has been disappointing (Kim & Chung, 2007). Over the years, the majority of SOCs have lacked budgetary discipline and governments have found it financially strenuous to keep on injecting capital into them as there are other competing government programmes that need funding. During the 1980s, the financial burden of these SOCs in most countries had grown so onerous, that it contributed to increasing public deficits, rising interest rates and growing inflation (OECD, 2004).

The poor performance of SOCs can be attributed to their structure and governance, which make them susceptible to poor accountability by management. In the private sector, should an entity underperform, the shareholders would withdraw from the business regardless of the social implications (Heath & Norman 2004). In the public sector, however, governments (who are the shareholder) constantly bail out SOCs when they are facing financial difficulties. Governments very rarely let an SOC become bankrupt. Unfortunately, these regular bailouts lead to the management of SOCs not being as financially efficient as management in the private sector (Heath & Norman 2004).

In Ghana, SOCs have been criticised for being overstaffed and inefficient, which resulted in considerable strain on government finances and inflation (Odainkey & Simpson, 2013). South Africa has also had its share of criticism relating to the performance of SOCs. The majority of these SOCs are failing to deliver on a number of key objectives, namely, efficient public service delivery, failure to meet the transformation needs of society, lack of skills transfer and job creation and failed to play a catalyst role in broader industrial development and expanding economic growth (Gumede, 2012).

Over the past recent years, South Africa's SOCs have been poorly governed and as a result, majority of them are currently in serious financial distress (McGregor's 2014). McGregor points to a poor selection system of board of directors; constant turn-over of executive managers as well as inadequate structures and systems as some of the major reasons which have led to the failure of these SOCs (McGregor**,** 2014).

It is worth mentioning that these SOC corporate failures are happening post the adoption of EE Act and the AA Programs (i.e. Post 1998).

## Racial Diversity in South Africa Corporate environment

South Africa has had a long history of racial discrimination that was created by the Apartheid regime. Subsequent to the Apartheid era, there has been numerous legislation adopted to drive transformation in South African Companies.

In 1998, the EE Act was adopted, the act was intended to end racial, gender, and ethnic discrimination in the workplace, and this act gave birth to AA policies and programmes (Tladi, 2001). The main objective of the AA was to correct the misrepresentation of the overall demographic of South Africa seen in the workplace. This AA programs were to ensure that companies give preferential treatment to previously disadvantaged racial groups (I.e. Blacks: Indians and Coloured) as well as women who were also discriminated against during the Apartheid era. The AA policies also required companies to develop the skills of these previously disadvantaged groups, and finally, to promote employment opportunities which are equal for all (Burger & Jafta, 2010; Tladi, 2001).

The 2014-2015 Commission for Employment Equity (Department of Labour, 2015) reported on the employment distribution of the various population groups in terms of their representation at the top management levels of organisations. The representation of white people decreased by 2.6% points from 72.6% in 2012 to 70% in 2014. Black representation increased slightly by 1.3% points, rising from 12.3% in 2012 to 13.6% in 2014. The representation of coloureds remained the same at 4.7%, while the representation of Indians increased by 1.3% points, rising from 7.3% in 2012 to 8.6% in 2014. Notwithstanding the fact that there is a steady but slow decline in the representation of whites, their domination remains, as they maintain more than a two-thirds majority in terms of representation at management level in organisations. This is of major concern since more than 80% of South Africans are black, and they are a significant majority in South Africa population.

A 2005 study by Webster, Karl von Holdt, revealed that, in South Africa the old racial colour bar that was created by apartheid laws in the working environment remained unchanged. The authors further state that even in rare cases where black people occupy senior positions, they usually earn less, and have fewer benefits and less responsibility as compared to their white counterparts. Booysen & Nkomo (2006); Selby & Sutherland (2006) and Thomas (2004) supported this statement in their studies and revealed that increasingly, black applicants are required to have higher qualifications for jobs once done by less-qualified white people.

From the above, it is evident that there could be barriers in South Africa's Corporates that are hindering black employees from progressing in the working environment. Ngambi (2002) and Thomas (2004), identified organisation culture issues, such as the exclusionary old white boys club, as historical organisational cultures, that create barriers and made it challenging to retain black employees and women at management level.

Selby & Sutherland (2006); Thomas (2004) state that even though South African anti-discrimination legislation is fundamental to addressing unfair workplace discrimination, legislation on its own is not sufficient. It is important to change organisational culture. These researchers are of the view that the implementation of EEA needs to be supported by comprehensible employment practices that focus on human capital development and are inclusive of practices and organisational culture change.

## The relationship between racial Diversity and Financial Performance

Advocates of diversity in corporate boardrooms usually base their arguments on agency, resource dependence, and stake holding theories (Goodstein, Gautam, and Boeker, 1994); Carter, D. A., Simkins, B. J., & Simpson, W. G. (2003)).

Firstly, agency theory suggests that executives and non-executives that come from diverse background rather than homogenous elite groups with similar socio-economic backgrounds, increases board independence and improves executive monitoring (Van der Walt and Ingley, 2003, p.219). Secondly, a diverse board of directors carries with it diverse ideas, perspectives, experience, and business knowledge to the decision-making process in boardrooms (Baranchuk and Dybvig, 2009, p.715). A diverse composition of board of directors also results in increased creativity and innovation in boardrooms due to diversity in cognitive abilities, which can also facilitate effective decision-making (Carter et al., 2003, p.36). Thirdly, resource dependence theory further suggests that companies that embrace diversity in their leadership structure attract and secure critical resources, including skills, business contacts, prestige and legitimacy (Goodstein et al., 1994, p.241) from the external environment. Fourthly, Rose (2007, p.405) argues that companies that have a diverse leadership convey a positive signal to potential female and ethnic minorities that they are not excluded from the highest positions within these diverse companies.

Drawing closer to home, Swartz and Firer (2005) investigated JSE listed companies and reported a statistically significant and positive association between the average percentage number of blacks (i.e. Blacks; Indians; Coloureds) and financial performance. These results were consistent with Ntim (2013b) who assessed 291 companies listed on the JSE over a five-year period and found a positive and statistically significant relationship between board diversity and the stock market valuation of the firm.

Another South African study by Yortt (2009) on the top 40 listed companies identified that at the time of her study, only 32.5% of the directors in the top 40 companies were Black, and only two of these listed companies had employed at least 50% Black executive directors. She also found a positive correlation between ethnic diversity and company performance which was measured in terms of both return on assets (ROA) and return on equity (ROE).

It is evident from the literature reviewed that there are financial benefits that come with the inclusion of black in the board of directors as well as in management positions however these studies have only tested JSE listed companies. The 1998 EEA, AA programmes as well as the introduction of the King Report (i.e. Code of Corporate Governance reports) require companies (particularly JSE listed Companies and SOCs) to set targets on the composition of executive and non-executive management in terms of their race and gender. These companies are also required to conduct regular reviews on these gender and race targets and to report them in their Annual Financial statements. The results of these disclosure and reviews is in order for these companies to disclose their diversity efforts and to reveal whether they represent the South African demographic population.

It is worth highlighting that the majority of studies conducted on the impact of race on performance are on JSE listed companies. The current study is unique as it is focused on SOC and will bring additional empirical evidences to the diversity-performance literature particularly considering the role of SOCs in South Africa. Furthermore, it is necessary to establish how government has implemented their own EE Act and policies in the SOCs and the impact of these on performance.

# Research methodology

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The main objective of this study was to determine the impact of racial diversity of management on the financial performance of SOCs.

## Data collection process

The PFMA requires all SOCs to publish their annual reports. These annual reports include both financial and non-financial information. In this study all 21 entities that are classified as major public entities in Schedule 2 of the PFMA were included in the population and sampled.

Each entity's annual report was obtained from each SOC's website for the five year (2010 to 2014) review period. Calculations of the Profit Margin; ROA as well as the Fruitless and Wasteful expenditure as a percentage of revenue were then derived from the financial statements. The information on the racial demographic of the executives were also obtained from the narratives of the annual reports. In most cases pictures of the executive management team was also included, which enhanced our investigation on the race of the executives.

<u>Measures</u>

It was important to identify and measure the two variables, being racial diversity and financial performance and to establish the nature of the relationship between these two variables. The independent variable in the study is the race (i.e. Black; White; Indian, and Coloured) of the executive management and the dependent variables is the financial performance (i.e. the SOC's profit margin, return on assets (ROA) as well as fruitless and wasteful expenditure. This study investigated whether the dependent variables (profit margin, ROA, etc.) changed when the management team was more racially diverse.

## Data analysis

In this study, the SPSS tool was used to determine the association between the diversity of executives' management and the financial performance of the SOCs. First the study analysed a statically descriptive of the two variables (i.e. race and financial performance). The results from this descriptive analysis are displayed in a graphical format (figure 1 and Figure 2 below) that shows the percentage number of Blacks; Indians; Coloured and White managers over the five-year review period. This graph displays the gradual improvement made by government to racially transform SOCs over the review period. In addition, the same descriptive analysis was conducted on the financial performance measures (i.e. profit margins, ROA, etc.) The results were also displayed in a graph that shows how the financial performance of these entities had improved over the five-year period.

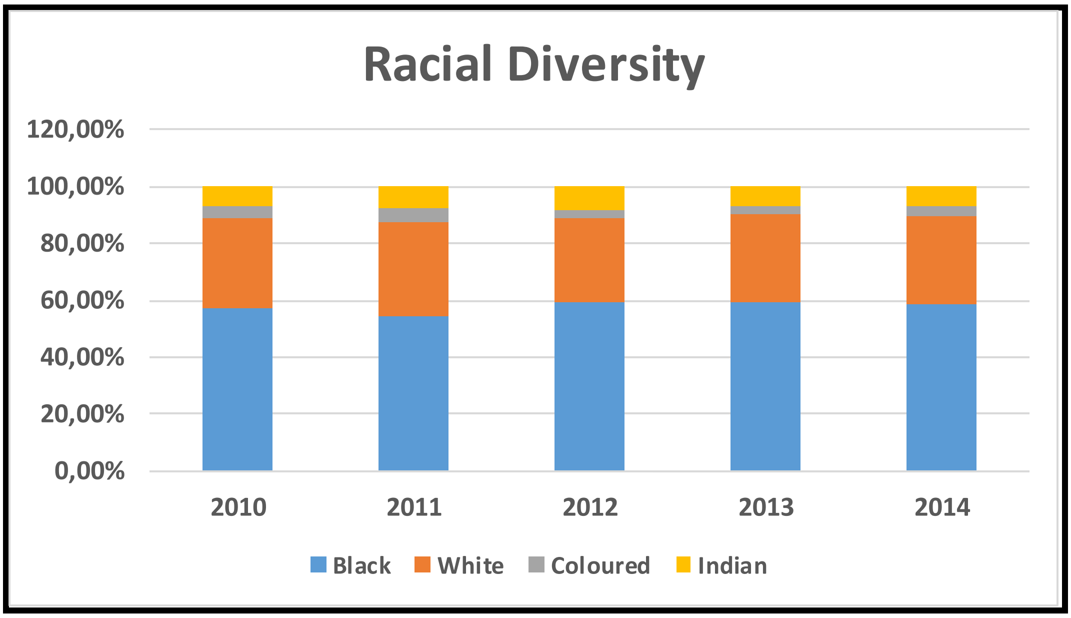
Finally, a correlation and regression analysis was conducted to demonstrate the specific effects of the independent variables (i.e. executives 'race) on the dependent variables (i.e. profit margins, ROA etc.). This analysis revealed how the SOCs' financial performance tended to change or vary with changes in executive managers' racial composition.

# Findings

The statistical results of this study demonstrate the racial diversity of executive managers in SOCs and how this racial diversity influence the companies' financial performance. Figure 1 and figure 2 illustrate the racial diversity and the financial performance on the SOCs over the review period. Demonstrating the improvement or regression in racial diversity as well as in the financial performance. The figures are followed by Table 1 to 3 which describe the correlation between racial diversity and financial performance.

## Racial diversity in SOCs

Figure 1: Analysis of Racial Diversity of SOCs



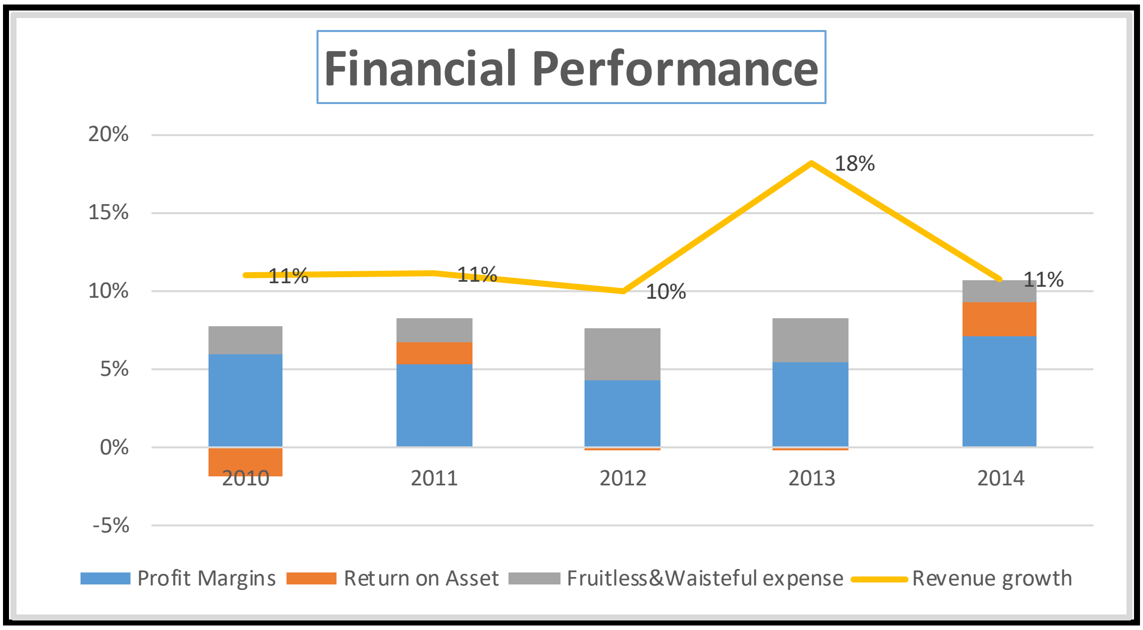

**Source**: SPSS Output

The above statistics indicate that the majority of executives in SOCs are non-white (approximately 69% in 2014). This translates to 58% Blacks, 7% Indians and the remaining 4% Coloured. The statistics further indicate that there are approximately 31% White executives in these SOCs. The graph also demonstrates an insignificant growth in the racial demographics of the executive management teams over the five years' review period (i.e. 2010- 2014)

However, it is worth mentioning that the racial diversity statistics in Figure 1 differ considerably from the current composition of South Africa's racial population. According to the 2014 mid-year statistical information reported by Statistics SA, South Africa's population had a representation of 80% blacks, 8.8% coloureds, 8.4% whites and 2.8% Indians. Therefore, even though the majority of the executives in these SOCs are non-white, their representation is substantially low and not consistent with the racial demographic of South Africa. The results suggest that the South African government as the owners of the SOCs have not effectively implemented the EE Act and that greater efforts still need to be made to racially transform these SOCs.

## Financial Performance in SOCs

Figure 2: Analysis of Financial Performance of SOCs




**Source**: SPSS Output

Similarly, a descriptive analysis was conducted on the financial performance of the SOCs. The results showed a total average of a 16.8% increase in revenue over the five-year review period. This increase stems from government's implementation of the New Economic Growth Plan (NDP Plan). During this period the South African government was investing funds into SOCs so they could implement the NDP plans. The implementation of the NDP plan resulted in an increase in profit margins as well as an increase in ROA. Also worth mentioning is that during this period the percentage ratio of fruitless and wasteful expenditure to revenue declined over the review period. This is an indication that during the review period, there was an increase in revenue and the fruitless and wasteful expenditures that was reported on was at a minimal level.

## The relationship between racial diversity and financial performance

Both correlation and a regression analysis were performed to determine the nature of the relationship between the demographic makeup of executives and the financial performance of the SOC.

The outcome of the correlation and the regression analysis on the executives' racial diversity and financial performance on the SOCs are summarised in Tables 1 - 3.

**Table 1**: Pearson correlations: Profit margin vs racial demographic variables

| | | Black | Coloured | Indian |
|---|---|---|---|---|
| Pearson Correlation | Profit Margin | -0.02 | 0.00 | -0.19 |
| Sig. (1-tailed) | Profit Margin | 0.44 | 0.50 | 0.03 |
| N | Profit margin | 99.00 | 99.00 | 99.00 |

**Source**: SPSS output

The results indicate that all the racial groups had an insignificant relation to profit margin. The analysis between profit margin and Indians showed an insignificant relationship of -0.19.,. Based on these results it was concluded that the demographic composition of SOCs executives had very little impact on profit margin.

**Table 2**: Pearson correlation: Return on asset vs demographic variables

| | | Black | Coloured | Indian |
|---|---|---|---|---|
| Pearson Correlation | Return On Assets | -0.094 | 0.086 | -0.084 |
| Sig. (1-tailed) | Return On Assets | 0.177 | 0.200 | 0.203 |
| N | Return On Assets | 99 | 99 | 99 |

**Source**: SPSS output

Table 23 shows no significant correlation between ROA and SOC executives that are Black, Coloured or Indian. This correlation analysis was followed by a regression analysis. The regression analysis also indicated no correlation between ROA and all racial groups.

**Table 3**: Pearson Correlation: fruitless and wasteful expenditure vs demographic variables

| | | Black | Coloured | Indian |
|---|---|---|---|---|
| Pearson Correlation | Fruitless & Wasteful | -0.133 | 0.247 | 0.056 |
| Sig. (1-tailed) | Fruitless & Wasteful | 0.095 | 0.007 | 0.292 |
| N | Fruitless & Wasteful | 99.00 | 99.00 | 99.00 |

**Source**: SPSS output

Table 3 above shows a positive correlation of 0.247 between fruitless or wasteful expenditure and Coloured executives. Additional analysis was performed and after the third iteration of the Cochrane-Orcutt estimation method, there was no correlation found between fruitless or wasteful expenditure and Coloured executive managers. When interpreting fruitless and wasteful expenditure as a percentage of revenue, one should bear in mind that during the period under review revenue was on the increase (due to investments made towards the NDP) therefore diminishing this particular ratio.

Furthermore, it should be considered that the sample size in this study is relatively small (i.e. 21 Companies were investigated) and this small sample has an impact when determining of the correlation. Consequently, in most cases the correlation and regression analyses showed an insignificant or no relationship.

In summary, the above results demonstrate that there has been very slow progress made by government in racial transformation in SOCs over the review period. The results further indicate an insignificant relationship between racial diversity and financial performance in SOC. This means the race of executive managers has no impact on the financial outcome of the SOCs.

# Conclusion and Discussion

The investigations from this study indicate that racial transformation in SOCs has been very slow at an executive level. This is of concern especially considering the fact that South Africa's government (who are the owners of these SOCs) implemented the EE Act two decades ago. Furthermore, the correlation and regression analyses, indicate that there is no significant relationship between the racial diversity of management and the financial performance of the SOCs. These results correspond to the study of Zahra and Stanton (1988) in which a correlation analysis was conducted on a sample of American companies, examining the relationship between women and ethnic minorities and found no relationship between the percentage of females and ethnic minorities on the board of directors and ROA and profit margin.

The results from the study suggest a clear need for more rigorous regulatory enforcement of policy-making in the areas of transformation and diversity such as a legislative quota similar to that of Sweden, where companies are obligated to have a certain percentage of women in their top corporate positions (Adams & Ferreira, 2009) in this instance the quotas will be based on inclusion of non-white employees.

It is also important to mention that the South African government, as the author of the EE Act, should take the lead when it comes to transformation and that their own companies, being the SOCs, must be well diversified and fairly represent the racial demographics of the country. If the South African government were to lead by example, the private sector would follow in its transformation of South Africa's working environment. Transformation in South Africa is not there only to correct the inequality of former South African Apartheid laws; it has been proven that transformation in South African JSE listed companies can also be financially beneficial.

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